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TAX

Tax Provisions in Administration's FY 2016 Budget Proposals

Financial Institutions & Products

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HIGHLIGHTS OF TAX PROPOSALS IN THE ADMINISTRATION'S FISCAL YEAR 2016 BUDGET RELATING TO FINANCIAL INSTITUTIONS AND PRODUCTS

KPMG has prepared a 111-page **book** that summarizes and makes observations about the revenue proposals in the Administration's FY 2016 budget. For ease of reference, we have compiled our summaries and observations relating to certain specific industries and topics in separate booklets. This booklet highlights revenue proposals relating to financial institutions and products. Other booklets will address proposals relating to the following topics:

- Insurance
- International Tax
- General Corporate Tax
- Tax Accounting
- Business Tax Credits
- Passthrough Entities
- Practice, Procedures, & Administration
- Charitable Deductions & Exempt Organizations
- Compensation, Benefits, & Qualified Plans
- Energy & Natural Resources
- Real Estate
- Closely-Held Businesses and Their Owners

Background

On February 2, 2015, President Obama transmitted to Congress the administration's recommendations to Congress for spending and taxation for the fiscal year that begins on October 1, 2015 (i.e., FY 2016).

Among other things, the president proposed a six-year $478 billion program for transportation infrastructure, the cost of which would be offset in part by a one-time tax on the unrepatriated foreign earnings of U.S. multinational corporations. This tax would be part of a transition to a proposed fundamental change in the taxation of the future foreign earnings of U.S. corporations that would effectively eliminate deferral of tax on foreign earnings, causing them generally to be taxed on a current basis at a reduced rate.

The president also proposed a reserve for business tax reform, but not one of sufficient magnitude for significant rate reduction. The president has called for reducing the corporate income tax rate to 28%, but the budget does not provide revenue to offset the cost of such a reduction. Instead, the budget refers only to eliminating tax expenditures, such as accelerated depreciation and "reducing the tax preference for debt financed investment."

Many of the “general” business tax proposals in the FY 2016 budget are familiar, having been included in previous budgets. These proposals include, for example:

- Reforms to the international tax system
- Limitations on the ability of domestic entities to expatriate
- Repeal of natural resources production preferences
- Repeal of LIFO and LCM accounting
- Taxation of carried interests in partnerships as ordinary income
- Insurance industry reforms
- Modification of the like-kind exchange rules
- Modification of the depreciation rules for corporate aircraft
- Denying a deduction for punitive damages
- Make permanent and reform the credit for research and experimentation

The president also re-proposed a tax on the liabilities of financial institutions with assets in excess of $50 billion. The rate would be reduced relative to the prior proposal from 17 basis points to 7 basis points, but the base of the tax would be different and the application of the tax would be significantly broadened to include insurance companies, savings and loan holding companies, exchanges, asset managers, broker-dealers, specialty finance corporations, and financial captives. These changes have roughly doubled the revenue raised relative to the proposal in the FY 2015 budget and are described in more detail later in this booklet.

The budget also includes a host of proposed changes to the individual income tax system. These include increasing the highest tax on capital gains from 23.8% (including the 3.8% net investment income tax) to 28%. In addition, a transfer of appreciated property would generally be treated as a sale of the property, subject to various exceptions and exclusions. For example, relief would be provided to lessen the immediate impact of the proposed change on the transfers of small businesses.

Financial Institutions and Products Tax Proposals

This booklet addresses the following budget proposals:

Impose a Financial Fee on "Financial Entities"

The administration proposes to impose a financial fee on financial entities. The administration cites excessive risk undertaken by major financial firms as a significant cause of the recent financial crisis and an ongoing potential risk to macroeconomic stability. The administration believes this fee will reduce the incentive for large financial institutions to leverage, reducing the cost of externalities arising from financial firm default as a result of high leverage. The structure of this fee would be broadly consistent with the principles agreed to by the G-20 leaders.[1]

The fee would apply to both U.S. and foreign banks; bank holding companies; and "nonbanks," such as insurance companies, savings and loan holding companies, exchanges, asset managers, broker-dealers, specialty finance corporations, and financial captives. Firms with worldwide consolidated assets of less than $50 billion would not be subject to the fee for periods when their assets are below this threshold. According to the Treasury Department's general explanation of the tax proposals of the budget—the so-called "**Green Book**"—U.S. subsidiaries and branches of foreign entities that fall into these business categories and that have assets in excess of $50 billion also would be covered.

[1] *See* Staff of the International Monetary Fund, "A Fair and Substantial Contribution by the Financial Sector: Final Report for the G-20" (June 2010).

The fee would apply to the “covered liabilities” of a financial entity. Covered liabilities would be “assets less equity for banks and nonbanks based on audited financial statements with a deduction for separate accounts (primarily for insurance companies).”

The rate of the fee applied to covered liabilities would be seven basis points, and the fee would be deductible in computing corporate income tax. A financial entity subject to the fee would report it on its annual federal income tax return. Estimated payments of the fee would be made on the same schedule as estimated income tax payments.

According to the administration’s estimates, the fee would raise $112 billion over 10 years and would apply to roughly 100 firms with assets over $50 billion.

The fee would be effective as of January 1, 2016.

KPMG observation

While the administration previously proposed a similar fee on financial institutions, this fee proposal is much broader in scope and in purpose. The fee was previously proposed as a means to recoup remaining costs of assistance provided through the Troubled Asset Relief Program. Now, for the first time, the fee is described primarily as a disincentive to incur excess leverage.

The proposed fee could apply to many types of institutions not previously covered by similar proposals. The proposed fee would apply not just to banks, but could also apply to insurance companies, exchanges, asset managers, broker-dealers, specialty finance companies, and financial captives. This would greatly expand the base of entities subject to the tax. It is unclear how some of these entities (e.g., asset manager and specialty finance companies) would be defined.

The proposal would effectively apply to foreign-headquartered financial institutions, i.e., branches of foreign entities that have assets in excess of $50 billion, and not just U.S. subsidiaries that meet the asset test. Some financial groups may end up with multiple groups subject to this fee, although the rule would presumably be drafted to avoid double-counting of assets and liabilities.

The definition of covered liabilities is also broader than prior proposals. Prior proposals excluded insured deposits from the calculation of covered liabilities. The current proposal would define covered liabilities as assets less equity based on audited financial statements, with no exclusion for deposits. The only exclusion would be for separate accounts, which primarily applies to insurance companies. It is unclear how this test would be applied to some of these types of entities (e.g., measuring assets and liabilities for entities with joint ventures).

Reform Treatment of Financial Products

Require that derivative contracts be marked to market with resulting gain or loss treated as ordinary

The timing and character of gain or loss on derivative contracts may vary under current law depending on how the contracts are classified or traded. For example, gain or loss with respect to a forward contract is generally recognized only when the contract is transferred or settled and is generally capital if the contract is a capital asset in the hands of the taxpayer. Certain futures contracts, in contrast, must be marked to market with capital gain or loss treated as 60% long-term and 40% short-term. Furthermore, certain options that are otherwise similar may be subject to disparate tax treatment depending on whether they are entered into over-the-counter or traded on certain exchanges.

Similar to the administration's FY 2015 proposal, the administration's FY 2016 proposal would generally require that a "derivative contract," as defined in the proposal, be marked to market annually (no later than the last business day of a taxpayer's tax year). Gain or loss would be recognized for tax purposes and would be treated as ordinary and as attributable to a trade or business of the taxpayer for purposes of section 172(d)(4). The source of income associated with a derivative would continue to be determined under current law. The proposal would also eliminate or amend a number of other provisions of the Code that address specific taxpayers and transactions, including section 475 (mark to market for securities dealers), section 1256 (mark to market and 60/40 capital treatment), section 1092 (tax straddles), section 1233 (short sales), section 1234 (gain or loss from an option), section 1234A (gains or losses from certain terminations), section 1258 (conversion transactions), section 1259 (constructive sale transactions), and section 1260 (constructive ownership transactions).

The proposal would define a "derivative contract" broadly to include any contract the value of which is determined, directly or indirectly, in whole or in part, by the value of actively traded property. An embedded derivative contract would also be subject to mark to market if the derivative itself would be. Thus, contingent debt or structured notes linked to actively traded property would be taxed as derivative contracts under the proposal.

In addition, actively traded stock that would not otherwise be subject to mark to market under the proposal would be required to be marked to market if it is part of a straddle transaction with a derivative contract (i.e., a derivative contract that substantially diminishes the risk of loss on the actively traded stock). Under such circumstances, pre-existing gain on the financial instrument would be recognized at the time of the mark, and loss would be recognized when such loss would have been recognized on the stock in the absence of the straddle.

The proposal would also provide the Secretary with the authority to issue regulations matching the timing, source, and character of income, gain, deduction, and loss from a capital asset and a transaction that diminishes the risk of loss or opportunity for gain from that asset. As an example, the proposal provides the following example:

> For example, in the case of stock issued by a U.S. corporation, the source of dividends on the stock would be U.S., while gain or loss on a sale of the stock is generally sourced based on the residence of the recipient. Thus, if a taxpayer were to hedge the stock with a notional principal contract (NPC), the Secretary would have the authority to write regulations that provide that dividend equivalent payments on the NPC are matched to the dividends on the stock for timing, source, and character, while gain or loss on the NPC could be matched to the gain or loss on the stock for timing, source, and character.

The proposal would not, however, apply mark-to-market treatment to a transaction that qualifies as a business hedging transaction. A business hedging transaction is a transaction that is entered into in the ordinary course of a taxpayer's trade or business primarily to manage risk of certain price changes (including changes related to interest rates, currency fluctuations, or creditworthiness) with respect to ordinary property or ordinary obligations, and that is identified as a hedging transaction before the close of the day on which it was acquired, originated, or entered into. The proposal provides that the identification requirement would be met if the transaction is identified as a business hedge for financial accounting purposes and it hedges price changes on ordinary property or obligations.

The proposal would apply to derivative contracts entered into after December 31, 2015.

KPMG observation

The administration's FY 2016 proposal imposes mark-to-market treatment on derivative contracts only when the value of the derivative contract is determined, directly or indirectly, in whole or in part, by the value of actively traded property. Although the administration's FY 2016 proposal would provide a framework for more uniform treatment of derivative contracts, taxpayers would still need to determine whether a particular financial instrument fits the definition of a derivative contract and thus be subject to mark-to-market treatment. Several details would need to be clarified, such as what constitutes actively traded property and what is an embedded derivative.

Require current inclusion in income of accrued market discount and limit the accrual amount for distressed debt

Market discount generally arises when a debt instrument is acquired in the secondary market for an amount less than its stated principal amount (or adjusted issue price, if it was issued with original issue discount (OID)). A holder of a debt instrument with market discount generally treats gain from a disposition of the instrument and principal payments under the instrument as ordinary income to the extent of the accrued market discount. Generally, market discount accrues ratably over the term of a debt instrument unless the holder elects to accrue on a constant yield basis instead. A holder may also elect to include market discount into income as it accrues.

The administration's FY 2016 proposal would require holders of debt instruments with market discount to include market discount currently in taxable ordinary income as it accrues. The proposal would require accrual of market discount on a constant yield basis. The proposal would also limit the accrual of market discount to the greater of: (1) the bond's yield to maturity plus 5%; or (2) the applicable federal rate for such bond plus 10%.

The proposal would apply to debt securities acquired after December 31, 2015.

KPMG observation

The proposal is based upon the premise that market discount that arises as a result of changes in interest rates or decreases in an issuer's creditworthiness subsequent to issuance is economically similar to OID, and like OID is to be accrued into income currently.

The proposal notes that current inclusion of market discount has historically been complicated by the fact that the amount of market discount on a debt instrument can vary from holder to holder since it is based upon each holder's acquisition price. The new information reporting rules would require brokers to include, on annual information returns, market discount accruals together with basis and other information for debt instruments, simplifying taxpayer compliance as well as the administrability of the proposal. Brokers are required to report cost-basis information, including market-discount accruals, for less complex debt instruments acquired after 2013 and more complex debt instruments acquired after 2015.

Require that the cost basis of stock that is a covered security must be determined using an average cost basis method

A taxpayer computes gain or loss upon disposition of stock as the difference between the stock's adjusted basis and its amount realized. Under current law, taxpayers who purchase identical stock at different times and for different prices may specifically identify which lots they sold. A first-in, first-out (FIFO) rule applies in the absence of a specific identification. An average basis method is permitted for stock in a regulated investment company, and for stock acquired in connection with a dividend investment plan.

For portfolio stock with respect to which the taxpayer has a long-term holding period, the administration's FY 2016 proposal would require taxpayers to determine the basis of stock sold using an average basis method. The average basis method would be applied to all identical shares of portfolio stock with a long-term holding period held by the taxpayer, including stock held through a different broker or in a separate account, but would not apply to shares held in a nontaxable account, such as an individual retirement account. The statute would provide authority to the Secretary to draft regulations applying the average basis method to stock other than portfolio stock. Special rules could also be required to coordinate the average basis method with the rules applicable to stock in passive foreign investment company.

The proposal would apply to portfolio stock acquired after December 31, 2015.

KPMG observation

The proposal would only apply to portfolio stock with respect to which a taxpayer has a long-term holding period, and only to portfolio stock acquired on or after December 31, 2015. However, it does not define portfolio stock. This term is defined in section 246A, but it is not clear that the proposal is relying upon this definition.

The proposal would also require taxpayers to apply average basis to all identical stock, whether held in the same account or multiple accounts with different brokers. Because the broker cost-basis reporting rules for stock apply on an account-by account-basis, the proposal would require taxpayers holding identical stock in multiple accounts to compute their average basis across accounts rather than relying upon annual statements provided by their brokers.

Mortgage Lender or Servicer Reporting

Improve mortgage interest deduction reporting

A deduction is allowed for qualified residence interest paid or accrued with respect to a primary residence and one secondary residence. A deduction is also allowed for property taxes paid. Any person, such as a lender or loan servicer, who in the course of their trade or business, receives from any individual interest aggregating $600 or more for any calendar year on any mortgage is required to report to the IRS on a Form 1098, *Mortgage Interest Statement*, with respect to each individual from whom interest is received. The IRS uses the information it receives on the Form 1098 to verify the deduction of qualified residence interest claimed by the individual on their tax return.

Under the FY 2016 proposal, in addition to the information already reported on the Form 1098, filers would also be required to include information regarding the outstanding principal balance of the mortgage as of the beginning of the calendar year; the address of the property securing the mortgage; information on whether the mortgage is a refinancing of an existing mortgage during the calendar year; property taxes, if any, paid from escrow; and the loan origination date.

The proposal would be effective for information returns due for calendar years beginning after December 31, 2015.

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